HARGREAVEHALE

INVESTMENT BULLETIN

Marlborough Funds;

SPECIAL SITUATIONS,
UK LEADING COMPANIES,
UK MICROCAP GROWTH

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I was struck by a client's recent request. On the face of it, a very sensible one. The question was: Can you please recommend me twenty UK shares with an above average yield, (he meant four to five per cent) which could provide good long term growth prospects, concentrated mainly in the FTSE 100 with perhaps a scattering in the FTSE 250. A very reasonable request, certainly one I would consider making to my own stockbroker, if I had one. Given current deposit rates, annuity rates and the disappearing state pension, such a portfolio would provide a neat solution to some of life's problems. You could sit back, Bertie Worster like, occasionally supplementing the 5% dividend stream with the odd capital gain, taxed at 28% rather than the 50% imposed on the UK's workers.

It did not take me long to give up. The definitions were simply too difficult to comply with. The market capitalisation of FTSE 100 and 250 stocks does not take into account pension fund deficits and pension fund deficits correlate to long term debt. Perversely the deficits reduce when interest rates rise and are devalued when inflation rises. But if you believe that it could be a some time before interest rates rise and inflation returns and if you want peace of mind, then you need to keep in mind that a pension fund deficit must be financed and pensioners are regarded as more important than shareholders. An example would be BT Group. On the face of it, a prospective yield well over 5%, free cash flow of £1.6 billion. But how much of this cash flow is dependent on fixed line services whose margins should reduce over time and what about the size of the pension fund, some £34 billion with a deficit which swings around £7billion which the company is trying to get the Government to take on. And the debt at the last published balance sheet amounted to £11 billion.

National Grid has a 6% yield and and enjoys steady cash flows given its status as a utility although it surprised the market earlier this year with a rights issue. National Grid has shareholders funds of over £4 billion but against that it has assembled over the years a debt structure of no less than £24 billion. A lot of this debt is long term out to 2035 and fixed rate, fine if you believe in a resurgence of inflation but not so fine if you believe in a low inflation environment and in tougher regulation in terms of profit margins. The Group's US business is now facing scrutiny from US regulators who are looking closely at its recent attempts to raise margins in Massachusetts and New York. A foreign company, US mid term elections, the US public feeling the pinch. In a country where regulation is tied much more closely to elected politicians, forcing through price increases worth around $500 million is not going to be easy. And with one third of its current profits derived from the US earmarked towards a committed investment programme in the UK of £22 billion, it does seem possible that more external finance might be sought from shareholders in the next few years.

Investors can obtain a near 6% yield on Land Securities. Even if they cut the dividend next year, which some analysts forecast, you could probably enjoy a yield of 4.85% which would be covered 1.2 times. But who wants such a dividend at the expense of capital values? There has been the odd tick up on market rallies but, by and large the share price has been trending doggedly downwards. The high for this year, for example was 694p, for 2009 it was 893p, for 2008 it was 1465p and for 2007 it was 1224p. It must be a fair punt that the next year sees a further fall in values. The Government has just said that it owns 78m sq ft of commercial space and it needs to cut this requirement to 44m sq ft. Walk up and down Whitehall, SWI, and you are looking at a lot of Land Securities buildings let to the Government. And Land Securities' heavy weighting in Central London offices makes the company vulnerable to the Coalition's commitment to outsource office requirements to the provinces. In the circumstances it seems likely that the benefits of an above average yield will continue to be negated by a falling share price.

And so it goes on, making the pipedream portfolio of income from within the FTSE 100 and FTSE 250 difficult if not impossible to achieve. There are of course a number of value traps such as big pharma, Glaxo, offering an above average yield of 5.3% and a prospective PER of around 7, the same valuation as its FTSE 100 peer, Astra Zeneca. Priced at 1280p, GlaxoSmithKline has yet to regain its 2024p price established nine years ago. Over the years, the twin fears of patent protection expiry, and inadequate pipelines of new drugs have more than compensated for apparently attractive cash flows, yields and earnings multiples.

The credit crunch has proved something of a watershed for well established market conventions, not least because it helped to shatter the complacency of investors in relation to "big name" banks. When your favourite friendly bank or building society seems on the way to the knackers yard and orderly queues start forming, and you get the sinking feeling that your Bradford and Bingley Perpetual, Irredeemable Pref might be something of a dead parrot, the shock is such that you start to reconsider your investment stance. Take away the dividend paying ability of banks such as LLoyds and Royal Bank of Scotland, both equity and preference shares, and suddenly if you want to invest in a good bank, such as Standard Chartered, you only get a dividend of 2% after tax, equivalent to a minus real return adjusting for inflation.

The idea that "Big Oils" like "Big Pharmas" can be depended on year in year out for dividend payments has been well and truly knocked on the head following the travails of BP. Ten years ago the big oil sector commanded a rating of almost 15 times earnings. It now trades on eight times earnings and possibly around 6 times next years earnings. The reason is not just rising costs and tax demands from producer countries but also the scarcity of opportunities which serves to increase the risk factors in getting oil out of the ground. There is at present a vocal lobby suggesting that the oil majors like Shell cut their dividends which look unsustainable given the rising cost of replacing reserves.

To labour the point, the old certainties which enabled investors to put together high yielding large market cap UK portfolios with some growth characteristics and sit on them through thick and thin have largely been destroyed by the frenetic pace of globalisation. The pace of globalisation and the cut throat nature of the competition engendered is now eating away now not just at UK corporates but at the fabric of the UK state because of the need to remain competitive and cut budget deficits. This does unfortunately put a question mark over a number of big cap UK corporates hitherto regarded as and rated as growth stocks. Examples would be Serco and Capita, trading on 2011 PER's of 15.9 and 16.4 respectively. Last month, Francis Maude, the Minister for the Cabinet Office met with 19 Central Government suppliers to discuss cutting expenditure. Capita has a 13.3% ebitda margin on its outsourcing business which looks vulnerable. It is true that revenues are backed by contracts often drawn up for ten years. But margins can and probably will be renegotiated first on contract re-bid and there could be trade offs on new bids involving renegotiation of margin.

Back to the client's original request. The increased risks attached to traditional UK equity investment make the pipedream portfolio a lot more difficult to achieve. There are still opportunities within the big cap UK market environment but they do not immediately conform to the parameters required by the client. An example would be British Airways which, having no dividend could not be included in the portfolio.

British Airways might well appear a curious choice in any portfolio. Saddled with large debts, a recalcitrant workforce, an ageing stock of planes, a big pension fund deficit and under intense competitive pressure as a result of a combination of emerging global low cost airlines and the recession.

But there are signs that the British Airways elephant is perhaps starting to walk slightly faster, goaded into action by a management in the form of Willie Walsh. A few initial steps have been taken. Step one, a pension agreement has finally been reached with the Trustees, involving no increase in the Group's pension fund contributions and a useful reduction in future accruing liabilities via a reduction in benefits agreed with the unions. This clears the way for Iberia to make its final decision on the merger by the end of this month.

Step two, and it is a big one, is the receipt of antitrust immunity from the regulatory authorities for BA's transatlantic joint business with American Airlines and Iberia, something that has been gestating for nearly fifteen years. American Airlines has indicated that annual synergy benefits accruing would be worth $150m to each airline, a figure supported by the BA management at its recent investor day. This does not include other potential benefits in terms of cost saving from co-location of facilities, joint advertising and purchasing.

What is interesting about the BA/Iberia merger and the joint venture with American Airlines is that it is all taking place more or less at the same time, which rather complicates things for investors but the new business will have approximately 20% of the Europe/US transatlantic market, sales in the joint venture of around $7 billion and much increased buying power in terms of fleets. As it is, BA seems to be generating improved levels of cash despite strikes and volcanoes as a result of higher yields and excellent cost controls. For the last quarter to June 2010, for example, the Group generated cash of £209m. As a result, earnings estimates have been upgraded sharply and some analysts are looking for 15p per share for the current year to March 2011, with 30p plus the following year, a prospective multiple of seven and this before any major savings are achieved via the merger and joint venture. There are even dividend forecasts for that year equivalent to a yield of just under 4%.

Nor can the management be said to be lacking ambition. At a recent investor day, it was revealed that Walsh is pursuing further industry consolidation using the platform of the joint venture with American Airlines and the merger with Iberia, targeting in particular carriers in Latin America and Asia.

A speculative, but potentially interesting investment, but as indicated certainly not suitable for the client's pipedream portfolio due to the lack of any dividend and the current risk profile. What the client really needs is a wider spread of global equities and to take advantage of the differential tax regime between dividend income and capital gains.

Which is a roundabout way to introduce three unit trusts whose investments we manage, the Marlborough Special Situations, the Marlborough UK Leading Companies and the Marlborough UK Microcap Growth. These funds together with our Hargreave Hale AIM VCT funds cover a wide spectrum of UK and global markets and benefit from investment managers and fund analysts such as Siddarth Chand Lall and Gracie XI Chen with experience and understanding of investment parameters in India and China respectively. The investment team numbers ten and reports to manager Giles Hargreave who makes all decisions in relation to the Special Situations and Microcap fund and Richard Hallett and Giles Hargreave jointly who make the decisions in relation to the Leading Companies fund. The Microcap and UK Leading Companies funds are both confined to the UK, but the Special Situations fund is a "go anywhere" fund which therefore has a global remit. The interaction of the team is vital because investment opportunities are now best viewed in a global perspective.

The traditional certitudes of big, medium sized, and small UK corporates servicing mainly specific markets in specific geographies has been effectively replaced by any sized corporates from any jurisdiction servicing just one world market. This throws up very interesting opportunities between the funds.

For example, one fund might be looking at BMW in view of its success in penetrating the Chinese luxury vehicle market. BMW would be suitable for a "go anywhere" fund, but there are repercussions for suppliers. UK quoted TT Electronics for example supplies sensors both to BMW and Daimler Benz and would therefore clearly be a beneficiary of their sales growth. At the same time, looking at the power market in Mexico, in an entirely different context, it emerges that TT has a major market share supplying uninterruptible power suppliers primarily to Mexico City. Such a company could be a suitable candidate for investment for both Special Situations and UK Leading Companies, 25% of whose investments can be in smaller companies.

The opportunities thrown up by globalisation can have very major impacts on the smallest of corporates. By way of example, the Microcap fund has a holding in Pittards, a very small UK corporate which is based in the West Country. Pittards has closed the majority of its high cost tanning and leather goods manufacturing in the UK, retaining a small design business and niche manufacturing for high valued added product. It has acquired one of the largest and lowest cost tanneries in the world, located in Ethiopia, a tannery which it had been managing for a number of years on behalf of the Ethiopian Government. Ethiopia is a prime source of global hides and the process of tanning is by its nature labour intensive. The cost of labour is roughly one sixtieth of the cost of comparable labour in the UK and is below the cost of labour in China, where rates have recently been increased by 40%. As a result of much enhanced cost competitiveness, Pittards is starting to win large orders and is welcoming back a number of customers lost over the past decade. These customers tend to be involved in the luxury leather business, which is growing strongly on the back of Chinese and Indian consumers. The recent interim figures reveal a doubling of half year profits to £0.8 million. At 2.5p, the market capitalisation is £10.8m, which makes an interesting comparison with the tax losses available to the Group of £11m.

These sort of global opportunities abound for corporates big and small and the aim is to capture these opportunities within the Special Situations, the Leading Companies and Microcap funds. In terms of comparative performance to date, being the year to September 13th, the FTSE 100 is up 13.61%, the FTSE 250 is up 15.92%, the AIM Index is up 18.51% and the Small Cap index is up by 4.8%.

In the same period, the Special Situations Fund is up 23.75%, the UK Leading Companies fund is up 24.68% and the Microcap fund is up 19.44%.

In peer group terms, Special Situations is 7th of out its sector of 60 funds in total, Leading Companies is 10th out of 312, Microcap is 20th out of 60, again over the last year. Further details of the fund performance is set out in the table below.

Marlborough Funds Performance Table

	Year 1 to 13/09/10	Year 2 to 13/09/09	Year 3 to 13/09/08	Year 4 to 13/09/07	Year 5 to 13/09/06
Special Situations	23.75	3.04	(20.88)	33.32	7.95
UK Leading Companies	24.68	(0.53)	(12.62)	15.78	19.29
UK Microcap Growth	19.44	10.13	(21.34)	32.43	8.7

Source: Morningstar
Basis: Bid-bid, UK basic rate tax, net dividends re-invested, based in GBP

In terms of more global comparisons according to confirmed figures published in FT.com the average hedge fund was up by 1.29% this year until the end of July, and rose a further 0.17 % in August.

In terms of consistency of performance, the following quote from the Investment Times September 2010 edition is relevant:

"Since launch in 1995 .... his fund ...(the Giles Hargreave managed Marlborough Special Situations Fund.)......is the top performing fund across all sectors and by some margin too. It has grown by 934% compared with 585% for its nearest competitor. .....he has managed this through the fall out from the tech bubble and the worst recession since the 1930's..... now that's what you call stockpicking."

Of course past performance is not a guide to future returns, as performance may not be repeated, share prices and dividend returns can go up, sideways and down, not always in that order. However, investment in these funds can be a good alternative to the pipedream portfolio spoken about earlier. You get a much better spread, you can have a wider global investment presence, and you are able to realise any capital growth and utilise capital gains tax allowances rather than taking dividend income, which at current tax rates is much more tax efficient. One way for much persecuted savers to protect themselves against being penalised by low deposit rates. However investors should be aware that tax treatment depends on individual circumstances and may be subject to future changes.

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